

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:MSR: [REDACTED] TL-N-LO-2099-99  
[REDACTED]

date: June 2, 1999

to: Chief, Examination Division, [REDACTED]  
Attn: Revenue Agent [REDACTED]

from: District Counsel, [REDACTED]

subject: [REDACTED]  
**Unpaid Loss and Loss Adjustment Expense**

You have requested advice on the proper method of analyzing unpaid losses in light of the Tax Court's recent opinion in Utah Medical Insurance Association v. Commissioner, T.C. Memo. 1998-458. Our discussion is contained below.

**Facts**

[REDACTED] (hereinafter "the company" or "the taxpayer") is a mutual insurance company which sells both life and non-life policies. Like other insurance companies, it sets up reserves for unpaid losses. The unpaid loss reserves claimed in the corporate income tax returns for property and casualty insurance for [REDACTED] through [REDACTED] are stated in the following chart (all numbers in [REDACTED]):

Year:	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Claimed Reserves:	\$ [REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
FAVORABLE DEVELOPMENT:					
As of [REDACTED]	\$ [REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Development %	[REDACTED]%	[REDACTED]%	[REDACTED]%	[REDACTED]%	[REDACTED]%
As of [REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Development %	[REDACTED]%	[REDACTED]%	[REDACTED]%	[REDACTED]%	[REDACTED]%

In the above chart the "claimed reserves" are the amounts initially set aside as reserves for any given year. For example, the initial reserve for unpaid losses for [REDACTED] was \$[REDACTED]. The "favorable development" indicates annual reductions in the reserves as of [REDACTED] and [REDACTED]. For example, as of the end of [REDACTED] the reserve for [REDACTED]'s unpaid losses had been reduced by \$[REDACTED] (a reduction of [REDACTED]% of the original reserve). As of the end of [REDACTED] the reserve for [REDACTED]'s losses had been reduced by \$[REDACTED] (a reduction of [REDACTED]% of the original reserve).

These reductions in the reserves are made by the company examining its own experience in claims made and claims paid and then reducing the reserves based on the re-calculation of anticipated losses. In effect, the write-down in the reserves is a recognition by the company that the reserves as originally determined were larger than proved to be actually necessary to pay claims. (Thus the name "favorable development," i.e., the amount which the company was obligated to pay out developed more favorably for the company than was originally anticipated.)

You are presently examining the company's returns for [REDACTED]. At present it is not clear how the taxpayer determined its reserves. You have issued an information document request (IDR) for the actuaries' reports in order to make that determination but have not yet received them.

In years before [REDACTED] the taxpayer had seriously underestimated its original reserves. As indicated by the chart, for all years since [REDACTED] the reserves have been larger than needed to pay claims.

#### Law

Under I.R.C. § 832(c)(1) and (4) a deduction is allowed to insurance companies for "losses incurred."

"Losses incurred" is defined in I.R.C. § 832(b)(5). It depends in part on the amount of "unpaid losses" outstanding at the end of the taxable year and the "unpaid losses" outstanding at the end of the preceding taxable year.

"Unpaid losses" are losses that have been incurred by the insurance company but not yet paid. Western National Mutual Insurance Company v. Commissioner, 65 F.3d 90 (8<sup>th</sup> Cir. 1995); Utah Medical Insurance Association v. Commissioner, T.C. Memo. 1998-458 (1998). For example, if an insured physician commits

malpractice resulting in harm to a patient during [REDACTED] but the patient has not yet been compensated as of the end of [REDACTED] the amount of the compensation yet to be paid by the insurance company is an unpaid loss as of [REDACTED].

Treas. Reg. § 1.832-4(a)(5) states:

In computing "losses incurred" the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

Under Treas. Reg. 1.832-4(b):

Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses. . . . These losses must be stated in amounts which, based upon the facts in each case and the company's experience with similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of unpaid losses which, in the opinion of the district director, are in excess of a fair and reasonable estimate will be disallowed as a deduction. The district director may require any insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred." [Emphasis added]

A fair and reasonable estimate of a taxpayer's unpaid losses is essentially a valuation issue and a question of fact. Hanover Insurance Company v. Commissioner, 69 T.C. 260, 270 (1977), aff'd 598 F.2d 1211 (1<sup>st</sup> Cir. 1979)

### Utah Medical

On December 30, 1998, the Tax Court issued its opinion in Utah Medical Insurance Association v. Commissioner, T.C. Memo. 1998-458. In Utah Medical the taxpayer was a company that provided only one product: Physician's malpractice insurance. Upon examination, the Internal Revenue Service challenged the amount of the reserves the company had deducted for unpaid losses for 1991 and 1992.

The company's actuaries had determined its estimated unpaid losses for each year as a range with high and low bounds (known as a "bounded range"). As required by law, however, the company claimed deductions in its tax returns for unpaid losses in specific amounts (a "point estimate"). The point estimates for the two years at issue were only slightly less than the high end of the ranges.

In determining the bounded range for each year, the company's actuary used both the taxpayer's and industry data in making his projections. Over time he increased the weight he gave to the taxpayer's data relative to industry data because more of the taxpayer's data was available.

The company established that 79% of its estimated unpaid losses for 1993-1995 eventually proved to be actual losses and that the medical malpractice insurance industry average for that figure was 81%. In other words, the taxpayer overstated reserves to virtually the same extent as the industry.

Every year as estimated losses were established and paid, the company reduced its remaining reserve for losses for earlier years. For example, for 1991 the reserve for that year was originally set at \$17,125,000. At the end of 1992 the loss reserve for 1991 was reduced to \$15,000,000. At the end of 1993 and 1994 the reserve for 1991 was reduced to \$14,520,000 and \$13,747,000, respectively. In determining the amount of these reductions the company relied on its own experience in paying claims.

The court concluded that, although the taxpayer's bounded range was large, it was reasonable because the company was relatively modestly capitalized, sold only one kind of insurance, served a limited geographic area, had relatively few claims (but the average cost of each claim was high), and medical malpractice policies are inherently risky and "long tailed" (i.e. claims can be made for many years after the year in which the injury occurred).

The court held that the company had proven by expert testimony that the company's method of determining the bounded ranges and point estimates were reasonable. The court held (based on the facts of the case) that each point in the range was reasonable, so the taxpayer could reasonably have claimed a deduction for any point in the range.

The court rejected the government's argument that (if the bounded range was reasonable) the taxpayer was required to use a point estimate that was in the exact middle of the bounded range.

The government also argued that, because the company had consistently overstated its unpaid losses for 1986-1990, the loss reserves for the years at issue (1991-1992) were not reasonable, i.e., the company in determining reserves for 1991-1992 should have noticed that it had repeatedly overestimated its reserves for five earlier years and therefore should have estimated smaller reserves for 1991-1992. The court rejected this argument. The court noted that the company had underestimated reserves for 1980-1985 and that the frequency and severity of claims began to increase significantly in 1990, so a high estimate of reserves for 1991-1992 was reasonable at the time that estimate was made. The court stated that "the fact that petitioner's loss estimates for 1986-92 proved, with hindsight, to be higher than actual payments does not make petitioner's choice of values unreasonable."

### Analysis

Utah Medical has caused considerable concern throughout the insurance tax industry. In our opinion, however, Utah Medical has not significantly altered the law and procedures applicable to the examination of your taxpayer.

The court in Utah Medical cited and relied upon the regulations promulgated under I.R.C. § 832. These regulations state that the estimate of unpaid losses must be "fair and reasonable" and must be determined "based upon the facts in each case and the company's experience with similar cases." The court cited with approval the holding in an earlier case that the determination of unpaid losses is essentially a valuation issue and a question of fact.

In Utah Medical the court determined as a matter of **fact** that the company's estimates of unpaid losses were reasonable at the time the estimates were made. This holding does not affect the basic applicable **law** (cited above) that requires the taxpayer to prove to the satisfaction of the Service that its estimates (as claimed on the returns) were fair and reasonable when it made them. There is nothing in Utah Medical that prevents the Service from inquiring into any facts which may be relevant to the company's determination. The Service's decision must be based on all the facts and circumstances.

Utah Medical provides some guidance to the Service in deciding whether the taxpayer's estimates were reasonable at the time they were made. It is clear that an insurance company can (with the assistance of an actuary) make "bounded ranges" of

unpaid losses and that it can derive "point estimates" from the bounded ranges to claim as deductions on tax returns. The Service cannot insist that the midpoint of a bounded range is the only reasonable point estimate. The company must prove, however, that it was fair and reasonable in determining both the bounded range and the point estimate. Although the court in Utah Medical found as a matter of fact that all of the points within the bounded range were reasonable, it did not hold that all of the points within a range must be reasonable. It depends on all the facts and circumstances.

The company, as required by regulations, must use industry statistics and its own experience in determining unpaid losses. The relative weight given to these factors depends on the facts of each case.

The court in Utah Medical made clear that the Service cannot determine that a company's estimate of unpaid losses was unreasonable based only on "hindsight." The determinative factor is whether the taxpayer's estimates were reasonable at the time they were made, regardless of whether they proved over time to be excessive. This does not mean that the company's previous experience is not relevant. For example, if you are examining a taxpayer for the year 1994 it is relevant if the taxpayer persistently overstated its unpaid losses for 1988-1993. Those years are relevant because the company, at the time it made the estimate for 1994, should have had the statistics for 1988-1993 in hand and should have consulted its own experience in determining the amount of unpaid losses to deduct for 1994. The company should have seen that its estimates were excessive for 1988-1993 and reason may have required it, in light of its own experience, to make a smaller estimate of unpaid losses for 1994. You cannot in making your examination of 1994 refer to any overstatement of unpaid losses for 1994 and later years, however, since such information was not available to the taxpayer at the time it made the estimate for 1994. Furthermore, excessive losses for 1988-1993, although relevant to your determination, cannot be the sole basis for determining whether the taxpayer's estimate for 1994 was unreasonable when it was made. All facts must be considered and (as in Utah Medical) the taxpayer may have had good reasons for making a large estimate of unpaid losses for a given year even though it overestimated unpaid losses (and knew it overstated unpaid losses) in the immediately preceding years.

We therefore advise that you examine all of the facts and circumstances. The favorable development ratios you have cited are evidence that the company's reserves for unpaid losses were excessive. As explained above, however, such evidence is not

conclusive. All facts must be considered, including the fact that the taxpayer (as in Utah Medical) had underestimated its losses in previous years. A thorough examination of the information and methods used by the company actuary must be undertaken when you have received the actuaries' reports in order to determine whether the company's reserves for unpaid losses were reasonable when they were made.

If you have any questions regarding this memorandum or need further advice, do not hesitate to contact us. You should also feel free to consult [REDACTED] the Examination ISP for property and casualty insurance.

[REDACTED]  
District Counsel

By: (Signed) [REDACTED]  
[REDACTED]  
Attorney